

**Introduced by Committee on Revenue and Taxation (Senators
Cedillo (Chair), Alpert, Bowen, and Burton)**

February 27, 2003

An act to amend Sections 17076, 23041, and 25111 of, and to add Sections 17049, 18405.1, 25113, and 25116 to, the Revenue and Taxation Code, relating to taxation, to take effect immediately, tax levy.

LEGISLATIVE COUNSEL'S DIGEST

SB 1061, as introduced, Committee on Revenue and Taxation. Income taxes: corporation taxes: claim of right: water's-edge.

The Personal Income Tax Law provides for various deductions in computing income subject to taxes.

This bill would provide that if an item was included in adjusted gross income of an individual because it appeared that the individual had an unrestricted right to the item, and that item is repaid in a later taxable year, then the tax of the individual will be recomputed based on excluding that item from income, as provided.

The Corporation Tax Law allows corporations to elect whether their income is determined on a "water's-edge" basis or on a worldwide unitary basis. The election to report income on a water's-edge basis is made by contract between the taxpayer and the Franchise Tax Board. The contract requirements allow no relief for errors, and do not allow the perfecting of invalid water's-edge elections. Electors who fail to comply with the contractual requirements for making a water's-edge election forfeit their water's-edge election, thereby causing their income to be determined on a worldwide unitary basis.

This bill would revise water's-edge election procedures by, among other things, providing that elections made under current law may be

perfected, and by providing, for taxable years beginning on or after January 1, 2003, that elections be made by statutory election, as provided, rather than by contract.

This bill would take effect immediately as a tax levy.

Vote: majority. Appropriation: no. Fiscal committee: yes.
State-mandated local program: no.

The people of the State of California do enact as follows:

1 SECTION 1. Section 17049 is added to the Revenue and
2 Taxation Code, to read:

3 17049. (a) If an item of income was included in the
4 California adjusted gross income of an individual for a preceding
5 taxable year or years because it appeared that the individual had
6 an unrestricted right to that item, and, based on the repayment of
7 the item by the individual during the taxable year, that individual
8 properly determines his or her federal income tax liability for the
9 taxable year under Section 1341(a)(4) or Section 1341(a)(5) of the
10 Internal Revenue Code, then the tax imposed by this chapter for
11 the taxable year on that individual shall be an amount equal to (1)
12 the tax for the taxable year computed without regard to this
13 section, minus (2) the decrease in tax under this chapter for the
14 preceding taxable year or years that would result solely from the
15 exclusion of the item or portion thereof from the adjusted gross
16 income required to be shown on the California return of that
17 individual for the preceding taxable year or years. This section
18 does not apply if the repayment is properly deductible in
19 determining the individual's federal adjusted gross income for the
20 taxable year, and that individual properly determines his or her
21 federal income tax liability for the taxable year under Section
22 1341(a)(4) of the Internal Revenue Code by deducting that
23 repayment.

24 (b) In determining the decrease in tax under this chapter for the
25 preceding taxable year or years that would result solely from the
26 exclusion of the item or portion thereof from the California
27 adjusted gross income of that individual for the preceding taxable
28 year or years, any item excluded from the California adjusted gross
29 income of an individual for a preceding year or years in which the
30 individual was a nonresident individual or part-year resident
31 individual, shall, to the extent that the item is derived from or

connected with sources within this state, be excluded from California adjusted gross income derived from or connected with sources within this state for that preceding year or years.

(c) If the decrease in tax under this chapter for the preceding taxable year or years that would result solely from the exclusion of the item or portion thereof from the adjusted gross income required to be shown on the California return of that individual for the preceding taxable year or years exceeds the tax for the taxable year computed without regard to this section, that excess shall be considered to be a payment of tax on the last day prescribed for the payment of tax for the taxable year, and, shall be refunded or credited in the same manner as if it were an overpayment for the taxable year.

SEC. 2. Section 17076 of the Revenue and Taxation Code is amended to read:

17076. (a) Section 67 of the Internal Revenue Code, relating to the 2-percent floor on miscellaneous itemized deductions, shall apply, except as otherwise provided.

(b) *A deduction allowable under this part that exceeds three thousand dollars (\$3,000) and is described in Section 17049, relating to computation of tax where a taxpayer restores a substantial amount held under claim of right, may not be treated as a miscellaneous itemized deduction under Section 67 of the Internal Revenue Code, as applicable for purposes of this part.*

SEC. 3. Section 18405.1 is added to the Revenue and Taxation Code, to read:

18405.1. (a) Notwithstanding Section 18405, the Franchise Tax Board may, in its discretion, permit elections made under Section 25111 to be perfected during the period of limitations prescribed under Sections 19057 and 19306 for the applicable taxable year. The statute of limitations of all taxpayers in a water's-edge group whose taxable year falls, in whole or in part, within the period of the election shall remain open to receive adjustments, under claim or deficiency, consistent with that perfection of the election.

(b) Subdivision (a) does not apply to the 1988 taxable year of any taxpayer whose water's-edge election has been perfected pursuant to Section 18405.

SEC. 4. Section 23041 of the Revenue and Taxation Code is amended to read:

1 23041. “Taxable year” means:

2 (a) For ~~calendar or fiscal years beginning before January 1,~~
3 ~~2000~~, the purposes of the tax imposed under Chapter 2
4 (commencing with Section 23101), the calendar year, or the fiscal
5 year for which the tax is payable.

6 (b) For the purposes of the tax imposed under Chapter 1.5
7 (commencing with Section 23081), Chapter 3 (commencing with
8 Section 23501), or Chapter 4 (commencing with Section 23701),
9 the calendar year or the fiscal year upon the basis of which the net
10 income is computed.

11 (c) For purposes of the tax imposed under Chapter 2.5
12 (commencing with Section 23400), (1) in the case of a taxpayer
13 subject to the tax imposed under Chapter 2 (commencing with
14 Section 23101), the calendar year or the fiscal year for which the
15 tax is payable and (2) in the case of a taxpayer subject to the tax
16 imposed under Chapter 3 (commencing with Section 23501) or
17 Chapter 4 (commencing with Section 23701), the calendar or
18 fiscal year upon the basis of which the net income is computed.

19 (d) For the purpose of the taxes imposed under this part, a
20 period of 12 months or less.

21 (e) When referring to a calendar or fiscal year beginning before
22 January 1, 2000, upon the basis of which the net income is
23 computed, the term “taxable year” shall mean “income year,” as
24 defined in subdivision (a) of Section 23042.

25 SEC. 5. Section 25111 of the Revenue and Taxation Code is
26 amended to read:

27 25111. (a) ~~The~~ *For taxable years beginning before January*
28 *1, 2003, the* making of a water’s-edge election as provided for in
29 Section 25110 shall be made by contract with the Franchise Tax
30 Board in the original return for a year and shall be effective only
31 if every taxpayer that is a member of the water’s-edge group and
32 which is subject to tax under this part makes the election. A single
33 taxpayer that is engaged in more than one business activity subject
34 to allocation and apportionment as provided in Article 2
35 (commencing with Section 25120) of Chapter 17 may make a
36 separate election for each business. The form and manner of
37 making the water’s-edge election shall be prescribed by the
38 Franchise Tax Board. Each contract making a water’s-edge
39 election shall be for an initial term of 84 months, except as
40 provided in subdivision (b). Each contract shall provide that on the

anniversary date of the contract or any other annual date specified by the contract a year shall be added automatically to the initial term unless notice of nonrenewal is given as provided in subdivision (d). An affiliated corporation that is a member of the water's-edge group and subsequently becomes subject to tax under this part or is a nonelecting taxpayer that is subsequently proved to be a member of the water's-edge group pursuant to a Franchise Tax Board audit determination, as evidenced by a notice of deficiency proposed to be assessed or a notice of tax change, shall be deemed to have elected.

No water's-edge election shall be made for a taxable year beginning prior to January 1, 1988.

(b) A water's-edge election may be terminated by a taxpayer prior to the end of the 84-month period if either of the following occurs:

(1) The taxpayer is acquired directly or indirectly by a nonelecting entity which alone or together with those affiliates included in its combined report is larger than the taxpayer as measured by equity capital.

(2) With the permission of the Franchise Tax Board.

(c) In granting a change of election, the Franchise Tax Board shall impose any conditions that are necessary to prevent the avoidance of tax or to clearly reflect income for the period the election was, or was purported to be, in effect. These conditions may include a requirement that income, including dividends paid from income earned while a water's-edge election was in effect, which would have been included in determining the income of the taxpayer from sources within and without this state pursuant to Section 25101 but for the water's-edge election shall be included in income in the year in which the election is changed.

(d) If the taxpayer desires in any year not to renew the election, the taxpayer shall serve written notice of nonrenewal upon the board at least 90 days in advance of the annual renewal date. Unless that written notice is provided to the board, the election shall be considered renewed as provided in subdivision (a).

(e) If the taxpayer serves notice of intent in any year not to renew the existing water's-edge election, that existing election shall remain in effect for the balance of the period remaining since the original election or the last renewal of the election, as the case may be.

(f) *To the extent that a taxpayer would have been required to file on a water's-edge basis in its first taxable year beginning on or after January 1, 2003, pursuant to a water's-edge election made in a prior year under this section, the terms of this section no longer apply and that election shall be deemed to have been made under the terms of Section 25113. However, the commencement date of the election made in a prior year under this section shall continue to be treated as the commencement date of the water's-edge election period for purposes of applying the provisions of Section 25113.*

SEC. 6. Section 25113 is added to the Revenue and Taxation Code, to read:

25113. (a) Except as provided in subdivision (f), for taxable years beginning on or after January 1, 2003, the election provided for in Section 25110 shall be made on an original, timely filed return for the year of the election. The election will be considered valid if both of the following conditions are satisfied:

(1) The tax is computed in a manner consistent with a water's-edge election.

(2) A written notification of election is filed with the return on a form prescribed by the Franchise Tax Board. Pursuant to regulations promulgated under this section, the Franchise Tax Board may accept the filing of other objective evidence that supports the conclusion that a water's-edge election was intended in lieu of notification on the designated form.

(b) Except as otherwise provided, a water's-edge election shall be effective only if made by every member of the self-assessed combined reporting group that is subject to taxation under this part.

(1) An election made on a group return of a self-assessed combined reporting group shall constitute an election by each taxpayer member included in that group return, unless one of those taxpayers files a separate return in which no election is made and paragraph (2) does not apply.

(2) A taxpayer that fails to make an election on its own timely filed original return shall be deemed to have elected if either of the following apply:

(A) It has a parent corporation that is an electing taxpayer that included the income and apportionment factors of the nonelecting taxpayer in the self-assessed combined reporting group reflected

1 in the electing parent's timely filed original return, including a
2 group return.

3 (B) The income and apportionment factors of the nonelecting
4 taxpayer is reflected in the self-assessed combined reporting group
5 of a timely filed original return of an electing taxpayer, and the
6 notification of election filed by the electing taxpayer pursuant to
7 paragraph (2) of subdivision (a) is signed by an officer or other
8 authorized agent of either a parent corporation of the nonelecting
9 taxpayer or another corporation with authority to bind the
10 nonelecting taxpayer to an election.

11 (3) For purposes of this subdivision, a "parent corporation" of
12 the taxpayer is a corporation that owns or constructively owns
13 stock possessing more than 50 percent of the voting power of the
14 taxpayer as determined under subdivisions (e) and (f) of Section
15 25105.

16 (4) If a corporation that is a member of a combined reporting
17 group is not itself subject to taxation under this part in the year for
18 which the water's-edge election is made, but subsequently
19 becomes subject to taxation under this part, that corporation shall
20 be deemed to have elected with the other taxpayer members of the
21 combined reporting group.

22 (5) A taxpayer that is engaged in more than one apportioning
23 trade or business as defined in paragraph (6) of subdivision (d) of
24 Section 25128 may make a separate election for each apportioning
25 trade or business.

26 (c) A water's-edge election shall remain in effect or be
27 terminated in accordance with this subdivision.

28 (1) Except as otherwise provided in this subdivision, if one or
29 more electing taxpayer members of a combined reporting group
30 later become disaffiliated or otherwise cease to be included in the
31 combined reporting group, the water's-edge election shall remain
32 in effect as to both the departing taxpayer members and any
33 remaining taxpayer members.

34 (2) If an electing taxpayer and a nonelecting taxpayer become
35 members of a new unitary affiliate group, the nonelecting taxpayer
36 shall be deemed to have elected if the value of the total business
37 assets of the electing taxpayer, and its component unitary group,
38 if any, is larger than the value of the total business assets of the
39 nonelecting taxpayer, and its component unitary group, if any.
40 Otherwise, the water's-edge election shall be automatically

1 terminated at the time the electing members become part of the
2 combined report. For purposes of applying paragraphs (9) and
3 (10), the commencement date of the deemed election shall be the
4 same as the commencement date of the electing taxpayers.

5 (3) If taxpayers filing under water's-edge elections with
6 different commencement dates become members of a new unitary
7 affiliate group, the earliest election date shall be deemed to apply
8 to all electing taxpayers if the total business assets of the earlier
9 electing taxpayer, and its component unitary group, if any, is larger
10 than the value of the total business assets of the later electing
11 taxpayer, and its component unitary group, if any. Otherwise, the
12 later election commencement date shall apply to all electing
13 taxpayers.

14 (4) (A) If a taxpayer with an election that has been terminated
15 under paragraph (9) or (10) becomes a member of a new unitary
16 affiliate group that includes another electing or nonelecting
17 taxpayer not affected by those paragraphs, any water's-edge
18 election of the other taxpayer member, if applicable, shall
19 terminate, and any restrictions on making a new water's-edge
20 election, relating to an election terminated under those paragraphs,
21 shall apply to all taxpayer members of the new unitary affiliate
22 group if the total business assets of the taxpayer with the
23 terminated election, and its component unitary group, if any, is
24 larger than the other taxpayer, and its component unitary group, if
25 any. Otherwise, paragraph (2) shall apply, if applicable. If
26 paragraph (2) does not apply, all taxpayer members of the new
27 unitary affiliate group will be treated as nonelecting taxpayers that
28 are not subject to any restrictions on making a new water's-edge
29 election.

30 (B) If two nonelecting taxpayers with different termination
31 dates under paragraph (9) or (10) become members of a new
32 unitary affiliate group, the earliest termination date shall be
33 deemed to apply to all nonelecting taxpayers, as well as any
34 restrictions on making a new water's-edge election relating to that
35 termination, if the total business assets of the earlier terminating
36 taxpayer, and its component unitary group, if any, is larger than the
37 value of the total business assets of the later terminating taxpayer,
38 and its component unitary group, if any. Otherwise, the later
39 termination date, and the related restrictions on making a new



1 water's-edge election, shall apply to all taxpayer members of the
2 new unitary affiliate group.

3 (5) (A) Except as provided in subparagraph (B), if one or more
4 electing taxpayers did not report their income and apportionment
5 factors as members of a combined reporting group with one or
6 more nonelecting taxpayers, and, pursuant to a Franchise Tax
7 Board audit determination, the nonelecting taxpayers, are properly
8 in the same combined reporting group as the electing taxpayers,
9 the water's-edge election of the electing taxpayers shall remain in
10 effect and the nonelecting taxpayers shall be deemed to have made
11 a water's-edge election. The commencement date of the deemed
12 water's-edge election shall be the same as the commencement date
13 of the electing taxpayers.

14 (B) Subparagraph (A) shall not apply if the value of total
15 business assets of the electing taxpayers does not exceed the value
16 of total business assets of the nonelecting taxpayers. In that event,
17 the water's-edge election of each electing taxpayer is terminated
18 as of the date the nonelecting taxpayers, and, pursuant to a
19 Franchise Tax Board audit determination, the nonelecting
20 taxpayers are, pursuant to the audit determination described in
21 subparagraph (A), properly included in the same combined
22 reporting group as the electing taxpayers.

23 (C) For purposes of applying the business asset test of this
24 paragraph, the term "business assets" shall have the same
25 meaning as subparagraph (A) of paragraph (6), except that the
26 business assets of other members of the unitary affiliate group that
27 are not taxpayers shall not be taken into account.

28 (D) Notwithstanding subparagraph (A), nonelecting taxpayers
29 may not be deemed to have made a water's-edge election if the
30 Franchise Tax Board audit determination described in
31 subparagraph (A) is withdrawn or otherwise overturned.

32 (6) For purposes of paragraphs (2) to (5), inclusive, the
33 following shall apply:

34 (A) "Business assets" are assets, including intangible assets,
35 other than stock of a member of the unitary affiliate group, which
36 are used in the conduct of the business of the unitary affiliate group
37 or would produce business income to the unitary affiliate group,
38 if an election were not in place, if the assets were sold. Business
39 assets shall be valued at net book value.

1 (B) The phrase “unitary affiliate group” refers to all of those
2 corporations that would constitute a unitary group if a
3 water’s-edge election were not made.

4 (C) The phrase “new unitary affiliate group” refers to a unitary
5 affiliate group that is created by a new affiliation of two or more
6 corporations, or by the addition of one or more new members to
7 an existing unitary affiliate group.

8 (D) The phrase “component unitary group” means that portion
9 of a group of corporations that have become members of a new
10 unitary affiliate group that were members of their own respective
11 unitary affiliate group prior to entering the new unitary affiliate
12 group, disregarding any corporations that did not become part of
13 the new unitary group.

14 (7) In the application of paragraphs (2) to (4), inclusive, a series
15 of acquisitions as steps of a single transaction shall be aggregated
16 as a single change of membership.

17 (8) In the event of a merger or consolidation, the water’s-edge
18 status and election commencement date or termination date of the
19 surviving corporation shall be consistent with the result that would
20 have been obtained under paragraphs (2) to (4), inclusive, if the
21 surviving corporation had acquired the stock of the transferor
22 corporation.

23 (9) A water’s-edge election may be terminated without the
24 consent of the Franchise Tax Board after it has been in effect for
25 at least 84 months. The termination shall be made on an original,
26 timely filed return for the first year in which the water’s-edge
27 election is to be terminated. To be effective, the termination shall
28 be made by every taxpayer that is a member of the water’s-edge
29 group in the same manner as the election provided under
30 subdivisions (a) and (b).

31 (10) A water’s-edge election may be terminated before the
32 84-month period described in paragraph (9) has elapsed, but only
33 with the consent of the Franchise Tax Board. A request for
34 termination shall be made at the time and in the manner specified
35 by the Franchise Tax Board. The request may be granted for good
36 cause. For purposes of this section, good cause shall have the same
37 meaning as specified in Treasury Regulations Section
38 1.1502-75(c).

39 (11) Except for deemed elections as provided in paragraphs (2),
40 (4), and (5), if a water’s-edge election is terminated under

paragraph (9) or (10), another election may not be made under this section for any taxable year that begins within the 84-month period following the last day of the election period that was terminated. The Franchise Tax Board may waive the application of this prohibition period for good cause.

(12) A water's-edge election shall remain in effect until terminated.

(d) For purposes of this section, the following shall apply:

(1) A "combined reporting group" means those corporations whose income and apportionment factors are properly considered pursuant to this chapter in computing the income of the individual taxpayer that is derived from or attributable to sources within this state, taking into account a valid water's-edge election.

(2) A "group return" refers to the single return which taxpayer members of a combined reporting group may elect by contract to file, in the form and manner prescribed by the Franchise Tax Board, in lieu of filing their own respective returns.

(3) A "self-assessed combined reporting group" means that group of corporations whose income and apportionment factors are reflected in a combined report prepared pursuant to this chapter in a timely filed return, taking into account the effects of a purported water's-edge election, whether or not the membership of the corporations in that combined report was correctly determined.

(e) The Franchise Tax Board may prescribe any regulations as may be necessary or appropriate to carry out the purposes of this section.

(f) To the extent that a taxpayer would have been required to file on a water's-edge basis in its first taxable year beginning on or after January 1, 2003, pursuant to a water's-edge election made in a prior year under Section 25111, the terms of Section 25111 shall not apply and the election shall be deemed to have been made under the terms of this section. However, the commencement date of the election made in a prior year under Section 25111 shall continue to be treated as the commencement date of the water's-edge election period for purposes of applying this section.

SEC. 7. Section 25116 is added to the Revenue and Taxation Code, to read:

25116. Notwithstanding paragraph (1) of subdivision (a) of Section 23051.5, when provisions of this article refer to provisions

1 of the Internal Revenue Code that do not otherwise apply for
2 purposes of Part 10.2 (commencing with Section 18401) or this
3 part, the term “Internal Revenue Code” means Title 26 of the
4 United States Code, including all amendments thereto, as in effect
5 for federal purposes for the taxable period, except as otherwise
6 specifically provided in this article.

7 SEC. 8. This act provides for a tax levy within the meaning of
8 Article IV of the Constitution and shall go into immediate effect.

